

Half Full or Half Empty? An Assessment of the Crocker Report on Iraqi Economic Conditions

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by Robert Looney

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Introduction

Ambassador Crocker's report to Congress on the progress made by the Iraqi economy is cautiously optimistic—clearly some progress is finally taking place. The encouraging news is that in some areas improved security is “stimulating revival of markets, with the active participation of local communities. War damage is being cleared and buildings repaired, roads and sewers built and commerce energized.”^[1] According to the Ambassador:

The IMF estimates that economic growth will exceed 6 percent for 2007. Iraqi ministries and provincial councils have made substantial progress this year in utilizing Iraq's oil revenue for investment. The 2007 governmental budget allocated \$10 billion (nearly one-third Iraq's expected oil export revenue) to capital investment. Over \$3 billion was allocated to the provinces and the Kurdish Region for spending. The latest data show that spending units (national ministries and provincial councils) have proceeded to commit these funds at more than twice the rate of last year. Doing the best are the provincial authorities, in the process gaining experience with making plans and decisions, and running fair tenders. In so doing, they are stimulating local business development and providing employment. Over time we expect the experience with more responsive local authorities will change Iraqi attitudes towards their elected leaders, and of the provinces towards Baghdad.^[2]

On the other hand the Ambassador went on to note that the “Iraqi economy is performing significantly under potential.” Insecurity in many areas results in increased transport costs thus raising the cost of production and limiting the size of markets for critical agricultural and manufacturing goods. While electricity supply has improved in many parts of the country, it is still insufficient for jumpstarting the economy of Baghdad and its environs. Many neighborhoods in the city receive two hours a day or less from the national grid, although power supplies for essential services such as water pumping stations or hospitals are much better.

As for the U.S. economic strategy in Iraq, Ambassador Crocker implicitly acknowledged a shift from the failed top-down, large infrastructure project approach that characterized the initial economic strategy to one focused on local development, and community-based support programs:

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We are deploying our assistance funds to make a difference to ordinary Iraqis and to support our political objectives. Military units are using Commanders Emergency Response (CERP) funds to ensure that residents see a difference when neighborhood violence declines. USAID Community Stabilization Funds provide tens of thousands of jobs. With the recent apportionment of 2007 Supplemental funds, we are putting "Quick Response Funds" in the hands of our Provincial Reconstruction Team leaders to build communities and institutions in post-kinetic environments. Vocational training and microfinance programs are supporting nascent private businesses. And in Baghdad, we are increasing our engagement and capacity building efforts with ministries.[3]

On the surface, Ambassador Crocker's assessment suggests that the shift in U.S. economic strategy in Iraq is finally on the road to successes after years of accomplishing little in the way of tangible gains in employment and improved standards of living for the vast majority of Iraqi citizens. Is this optimism warranted? Or, are there still serious problems lurking beneath the surface? Are there other forces at work that cast doubt on the sustainability of the country's recent economic successes?

Progress from a Macroeconomic Perspective

Much of the optimism concerning the Iraqi economic recovery comes from the IMF's recent assessment of progress made under the country's Stand-By-Agreement with the Fund.[4] While the fund is projecting an economic expansion of 6 percent in 2007, it is with a number of caveats and uncertainties. The Iraqi economy is still oil-based, so the 6 percent growth rate is based on the assumption of a modest increase in oil production—reaching 2.1 million barrels per day (mbpd) with stable prices. However, the Fund goes on to note that:

The economy remains extremely vulnerable to the country's security problems, which impede investment, inhibit private economic activity and hamper implementation of the structural reform agenda. In the event that investment and production in the oil sector cannot be increased as projected, lower oil revenue would result in higher fiscal deficits and sizable financing gaps from 2008. Absent access to significant external borrowing, spending cuts would be necessary and unavoidable. The debt sustainability analysis indicate that Iraq's external debt remains also vulnerable to negative oil price and production shocks.[5]

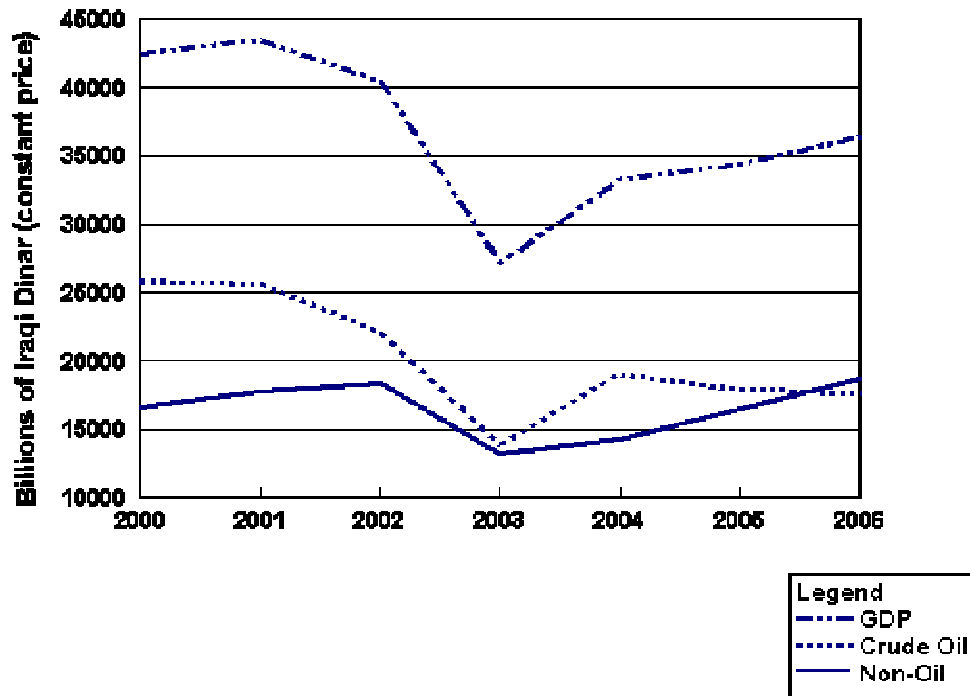
In short, the Fund's forecast of 6 percent rate of growth is under the assumption that no major unanticipated negative shocks hit the economy. If this does occur, the Fund cautions that the Iraqi authorities could do little to stem their adverse effects. The result might be a rate of growth considerably below 6 percent.

The IMF report also presents one of the more complete sets of data on the Iraqi economy. The disaggregated macroeconomic data reveals several interesting trends that also raise questions on the sustainability of the country's recent economic expansion. While the quality of Iraqi data is always in question, there are several distinctive trends that even errors in the data cannot conceal. Given the slow expansion in oil production and its unfulfilled potential,[6] the economy has grown over the last few years largely through an expansion in the non-oil economy (Figure 1). In fact, oil production has fallen from 3.5 mbpd to about 2 mbpd since the overthrow of Saddam Hussein.

What are the chances of a major recovery in oil production? Much depends on the manner in which the country's controversial draft hydrocarbons law is resolved. Will it be approved by the Parliament? If it is signed will oil companies flock to the country bringing the technology and billions of investment needed to revive the industry?[7] Since signing the draft law is part of the benchmarks for progress laid down by the U.S. Congress, it will no doubt eventually become law.

On the other hand, the prospects are not particularly bright concerning an infusion of new investment into the dilapidated industry.

Figure 1: Iraq: Trends in Gross Domestic Product and Main Components



Source: Compiled from: International Monetary Fund, Iraq: Statistical Appendix, IMF Country Report No. 07/294 (Washington: International Monetary Fund, August 2007), 3.

Muhammad-Ali Zainy, the former adviser and now senior energy economist at London-based Center for Global Energy Studies, says it is unlikely the international oil companies will be invited within the next few years. "I do not think IOCs will come to Iraq any time soon merely because of the terrible security situation."^[8] If this is the case, the country as in the last several years will become more dependent on the non-oil economy for growth and employment creation. Is this sector up to the challenge? Here a very mixed picture emerges.

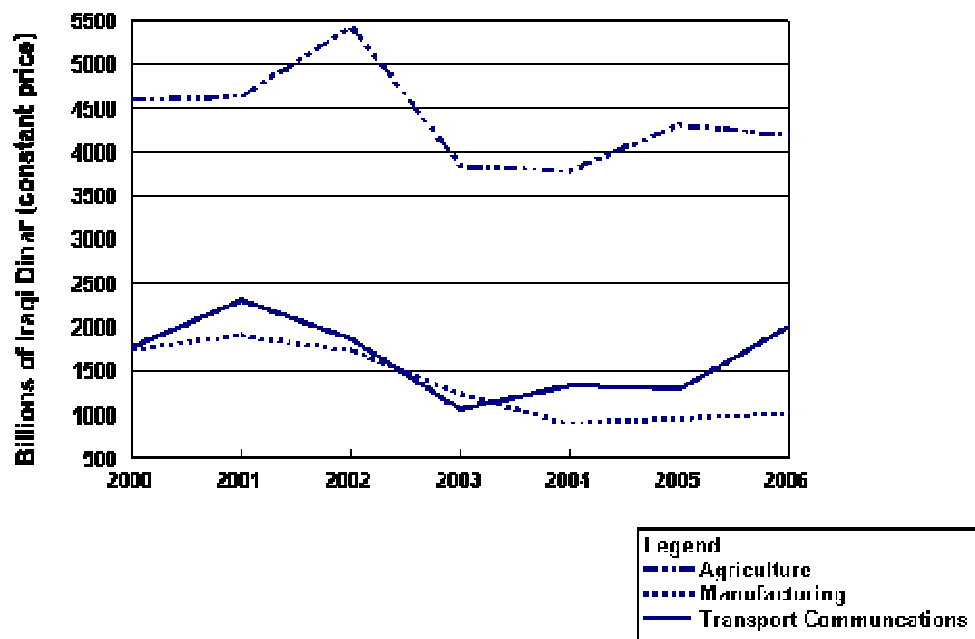
Analyzing data from the World Bank on Iraqi GDP according to type of expenditure suggests that the economy has been heavily dependent on consumption rather than investment. Consumption expenditure accounted for more than 90 percent of GDP on average for the period 2004-06. To a large extent, therefore this expansion has simply restored non-oil output to levels reached in 2002. As excess capacity is eliminated, sustaining non-oil output will be more dependent on new investment rather than the demand driven restoration of previous production levels.

Another problem in assessing the sustainability of recent non-oil macroeconomic trends relates to the inability of the data to distinguish between new activity and activity that previously existed in the informal economy. Specifically, shifts from the informal to formal economy would not improve total output and employment, but simply reflect the non-counting of this activity (when it was underground) to its inclusion in the national income accounts when the activity transitioned into more formal channels.

Rough estimates of the informal or shadow economy exist. Before the fall of Saddam Hussein the country's informal activity was estimated at around 35 percent of GDP with approximately 68 percent of the labor force population engaged in informal activities. This figure amounted to around 32 percent of the population engaged in informal activities that were not counted as part of the country's official level of output and employment. With the fall of Saddam Hussein and the disruption of many formal channels and networks, the size of the underground economy may have increased to as much as 65 percent of GDP.[9] Over time as many of these activities are likely to have returned to more formal arrangements, especially in the more stable regions and provinces outside of Baghdad. If this is the case the reported growth rates are biased upwards because they do not reflect "new" output, but simply a reclassification of existing production from informal (where they are not counted) to formal (where they are counted)

Within the productive sectors this shift from informal to formal activity is probably the highest in agriculture, where farmers can transition from self consumption and local barter to more formal markets as the rural security situation improves and distribution networks revived. The IMF data (Figure 2) show that the non-oil sector is dominated by agriculture. Here expansion has been weak, with production not yet returning to the levels achieved in the last years of the Saddam Hussein regime. More troubling is the fact that there does not appear to be a strong recovery underway, with output actually falling in 2006. This pattern is particularly disappointing because of the productive sectors agriculture probably has the highest growth potential. Given that a large percentage of the population is dependent on agriculture for their livelihoods, a broad based economic expansion on the supply side is unlikely until the sector recovers.

Figure 2: Iraq: Trends in Major Productive Sectors



Source: Compiled from: International Monetary Fund, Iraq: Statistical Appendix, IMF Country Report No. 07/294 (Washington: International Monetary Fund, August 2007), 3.

Progress in the critical manufacturing sector has also been disappointing. The sector has been on the decline for some time with the ailing state enterprises of the Saddam Hussein regime increasingly unable to maintain production levels. The sector's contraction leveled off in 2004 with little or no expansion in the last several years. One new U.S. initiative under the direction of Paul

Brinkley^[10], the Under Secretary of Defense for Business Transformation, is to jump-start the sector by opening up a number of old state enterprises, many of which have been shut for years due to their high costs, uncompetitive outputs or stripped assets.

Resurrection of the country's state owned enterprises has been extremely controversial with the State Department and the Department of Defense (DOD) each adamantly opposed to the project at one time or another. There has been no period when both were whole-heartedly behind the project. Lack of cooperation between U.S. government agencies will no doubt ultimately doom the project. As Rajiv Chandrasekaran recently observed:^[11] "Paul Brinkley, a deputy undersecretary of defense has been called a Stalinist by U.S. diplomats in Iraq. One has accused him of helping insurgents build better bombs. The State Department has even taken the unusual step of enlisting the CIA to dispute the validity of Brinkley's work." Given the history of this program it is no surprise that it is currently fraught with problems.

... the implementation of that strategy has proved far more complicated and controversial than anyone expected. Money to get the factories restarted has been hard to come by. Finding buyers for the goods in the U.S. has been even harder (only one company, a small Memphis retailer, has signed on so far). And that's on top of the Herculean challenges of doing business in a war zone where electricity is erratic, supplies are scarce, and employees can get blown up on the way to work.^[12]

On the other hand the increase in income derived from transport and communication suggests that the rebuilding efforts have created a number of linkages with the non-oil economy, perhaps laying a foundation for further growth. In fact, Ambassador Crocker noted that the expansion in cell phones was one of the major indicators of economic success in the country. As he noted "An auction of cell phone spectrum conducted by PricewaterhouseCoopers netted the government a better than expected sum of \$3.75 billion."

Again caution must be exercised in interpreting these trends and translating them into indicators of economic success. Brian Beutler has summarized other interpretations of increased cell phone usage:^[13]

The cell phone market in Iraq is indeed growing fast, and it's that market that drove competition for the country's wireless spectrum at last month's auction. But a rapidly growing cellular market is both difficult to quantify and, ironically, can be a sign of economic weakness. Alex Rossmiller worked in Iraq as an intelligence office for the Department of Defense. He says "cell-phone use in Iraq is skyrocketing, primarily because the land-line infrastructure is so degraded, both from neglect during Saddam's rule and from our military operations against communications facilities in 2003." Similarly, Daniel Sudnick, who worked at the Coalition Provisional Authority as Paul Bremmer's senior adviser for communications, described it as an "irony" that part of the reason the cell phone industry has flourished is that resistance fighters don't often attack towers and other cell phone infrastructure, for a simple reason: They depend upon mobile phones, too. Moreover, Sudnick says the unstable monthly contracts are evidence of a broken system. "The economic reality in Iraq hasn't changed fundamentally since I've been there. They don't have a reliable, robust banking system over there. It's still a cash economy. And the only way to retain payment is with a prepaid system."^[14]

Finally, the pattern of growth in the service sectors reveals the private sector's lack of dynamism. The growth in retail/wholesale trade as well as financial services has been particularly flat with oil revenue and aid financed social services accounting for nearly all of the expansion in this sector's activity (Figure 3). Given the oil sector's likely limited expansion in the medium term, sustaining social service expenditures at current rates is somewhat problematic. Of course foreign aid and debt relief can assist the government's ability to spend in this area but even here there are serious uncertainties.

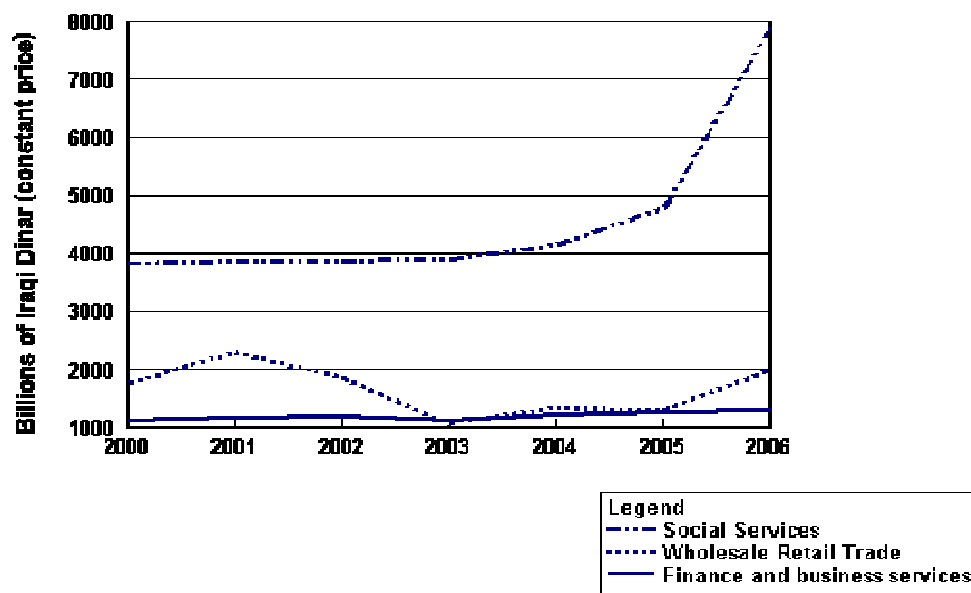
Given the likely reduction in U.S. aid, the chief mechanism for financing Iraqi reconstruction is likely to become the International Compact for Iraq. This is a five-year plan involving many of the regional countries as well as the leading industrial countries. Its aim is debt relief and foreign assistance for Iraq on the provision that the Iraqis themselves carry out required political, economic and social development initiatives—many similar to the benchmarks laid down by the U.S. Congress. Specifically, the Iraqi government must commit to take long-delayed actions, inducing political reconciliation, constitutional amendments, disbanding of militias, easing of a ban on former Ba'ath Party members, and passage of a law to ensure equitable distribution of Iraq's oil wealth.^[15] Despite the obvious benefit to Iraq, the Iraqi government has to date made little or no progress in these areas.

Finally, Ambassador Crocker's report to Congress does not touch on the corrosive effect inflation is having on the economy. The consumer price index rose by 30.5 percent year-on-year in July 2007, with the fuel component of the index rising by 90.2 percent. As with any inflation, fixed income groups in Iraq are suffering the most. In venting their anger at the government, the effected groups will no doubt create even more political instability. Reconstruction efforts are also being distorted by the rise in local prices and higher labor costs (in dollar terms). Since the majority of government spending is denominated in dinars, more oil export earnings (denominated in dollars) are required for any given item. "This is making the use of non-Iraqi regional manpower more attractive as it is cheaper than employing an Iraqi workforce, thereby undermining economic regeneration."^[16]

Progress from a Regional Perspective

While the macroeconomic perspective provides some insights, both encouraging and discouraging, as to the nature of economic progress to date, one does not get a sense of the geographic dimension of activity. Clearly all parts of the country are not making comparable strides in reconstruction or recovery.

Figure 3: Iraq: Trends in the Service Sectors



Source: Compiled from: International Monetary Fund, *Iraq: Statistical Appendix*, IMF Country Report No. 07/294 (Washington: International Monetary Fund, August 2007), 3.

As Ambassador Crocker correctly implies, improved economic conditions quickly follow political and security successes:

In al-Anbar, the progress on the security side has been extraordinary... Tribal representatives are on the provincial council, which is now meeting regularly to find ways of restoring services, developing the economy, and executing a provincial budget. These leaders are looking for help to rebuild their cities and talking of attracting investment. Such scenes are also unfolding in parts of Diyala and Ninewa, where Iraqis have mobilized with the help of the Coalition and Iraqi security forces to evict al-Qa'ida from their communities. The world should note that when al-Qa'ida began implementing its twisted vision of the Caliphate in Iraq, Iraqis, from al-Anbar to Baghdad to Diyala, have overwhelmingly rejected it.

However, he goes on to warn that success is far from automatic:

A key challenge for Iraqis now is to link these positive developments in the provinces to the central government in Baghdad. Unlike our states, Iraqi provinces have little ability to generate funds through taxation, making them dependent on the central government for resources. The growing ability of the provinces to design and execute budgets and the readiness of the central government to resource them are success stories. On September 5, Iraq's senior federal leadership traveled to al-Anbar where they announced a 70 percent increase in the 2007 provincial capital budget as well as \$50 million to compensate losses in the fight against al-Qa'ida. The support of the central government is also needed to maintain hard-won security in areas like al-Anbar through the rapid expansion of locally-generated police. The Government of Iraq has placed some 21,000 Anbaris on police roles.

An independent assessment, made by Stuart W. Bowen, the Special Inspector General for Iraq Reconstruction (SIGIR), also notes some bright spots:[\[17\]](#) economic growth in the Kurdish north;[\[18\]](#) tribal reconciliation in the western desert province of Anbar; and patchy progress in the development of local governments. Beyond that, some of the provinces are showing increasing ability to create plans, write contracts and carry out construction projects to rebuild Iraq's physical infrastructure.[\[19\]](#) Skill shortages are, however impeding progress in many local governments and ministries.[\[20\]](#)

Unfortunately, many factors are still impeding progress in key areas across the country. For example:[\[21\]](#)

- the failure of the Council of Representatives to pass a provincial powers law that defines local governments' rights and responsibilities has limited provincial councils' effectiveness in managing their governmental institutions;
- weak and uncoordinated rule of law programs within the provinces and at the national level have been a continuing problem. In most provinces, there is little cooperation;
- judicial orders are routinely ignored by the police, courts, and correction facilities;
- efforts to increase local living standards and reduce unemployment have been undermined by the dangerous security situation, but micro-lending programs, agribusiness development, and small-business development programs are beginning to make headway;
- provincial governments have limited capacity to manage and sustain infrastructure and to budget for operations and maintenance, but some

- improvements have been noted in Iraqi management of local reconstruction projects; and,
- local political reconciliation efforts have been undermined in some areas by rival Shia groups, a sense of alienation among Sunnis, and growing frustration over the inability to obtain government services.

At the risk of over-generalizing, the overall picture is one of high investment and rapid increase of incomes in the Kurdish regions, promise of stability and improved prospects in the Sunni region of Al-Anbar, continued stagnation in Baghdad with limited pockets of progress in the Southern provinces. For all practical purposes vast stretches of the South are outside the influence of U.S. or British reconstruction efforts. They are even outside the control of the central government.

In Basra province, a British-led team of reconstruction experts abandoned its offices in the provincial capital last November after repeated rocket and mortar attacks, and coalition reconstruction teams, including members of the Army Corps of Engineers no longer travel to Maysan province, which is now dominated by the Mahdi Army militia of radical Shiite cleric Muqtada al-Sadr.[\[22\]](#)

One danger of the development of distinct regional economies—the balkanization of Iraq which may in the longer term impede efforts to consolidate the country around a strong central government. There are already an increasing number of examples of provinces defying the central government through such actions as withdrawing their electricity generation from the national grid.[\[23\]](#)

Overall Assessment

Clearly some economic progress is being made in Iraq. Whether it is too little or too late is the real question. Can the incremental improvements over the last year or so somehow be the basis for the creation of a virtuous circle of improved standards of living leading to a lessening of violence in turn leading to higher rates of investment and economic expansion is still an unanswered question.

People who study the overall situation in Iraq and put their money on their assessment as to the country's future prospects remain skeptical of the country's prospects. This is revealed in movements in the price of Iraqi state bonds that the Iraqi government is currently servicing on world financial markets. Importantly, these bonds trade on world financial markets; for example, hedge funds hold a substantial fraction of them and their price on the secondary market is quoted in Bloomberg's financial data services. The appeal of using financial markets is that traders' only concern is to make profitable decisions and this necessarily requires making correct projections.[\[24\]](#) There isn't room for personal biases in this setting. Consequently, it isn't surprising that these markets have a good track record at predicting uncertain future events. Using this approach a recent MIT study found that:

Overall, the bond market findings fail to support the view that the Surge is helping to pave the way for the emergence of a stable Iraq and may in fact be undermining it. After the Surge, the Iraqi bonds' yield increased by 115 to 170 basis points, relative to comparison bonds. This translates into an approximate 40 percent increase in the expected annual probability of default. In other words, the world financial markets are saying that Iraq's prospects declined after the Surge.[\[25\]](#)

What accounts for this sad state of affairs? Clearly the failure to integrate economic programs more tightly with political and military dimensions is a major factor. Since the overthrow of

Saddam Hussein the economy has largely been an afterthought with the result that political and military gains are hard to sustain in an environment of grinding poverty and unemployment.

One of the main lessons learned from the British experience in Southern Iraq was that:[26]

In conditions of economic stagnation the security forces find that they are dealing with general public order issues caused by significant numbers of ordinary disgruntled Iraqis, rather than the pure terrorist threat. What is required is a balanced approach with equal focus on the redevelopment of the domestic economy as well as the rebuilding of the domestic security forces.

Hopefully, there is still time for the country to develop a more coherent and integrated economic strategy[27] so that the next Crocker report to Congress will set the tone of a half full economy rather than the present half empty state of affairs.

About the Author

Robert E. Looney is professor of National Security Affairs at the Naval Postgraduate School. He specializes in issues relating to economic conditions and security in the Middle East and South Asia. He has had extensive field work in Iran and Saudi Arabia and has published twenty books on various facets of economic development, economic intelligence and macroeconomic modeling. He is currently working on a book forecasting alternative futures for the Iranian economy. In addition, he has over 200 articles appearing numerous professional journals. His recent writings on the Iraqi economy can be found at: <http://web.nps.navy.mil/~relooney/Iraq-Pubs.htm>.

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